Legislative Audit Division

State of Montana

Report to the Legislature

January 2003

Financial-Compliance Audit

For the Two Fiscal Years Ended June 30, 2002

Montana State Fund

We performed a financial-compliance audit of the Montana State Fund for the two fiscal years ended June 30, 2002. This report contains the audited financial statements and accompanying notes for fiscal year 2001-02, with comparative fiscal year 2000-01 amounts. We issued an unqualified opinion on the financial statement information presented.

This report contains no recommendations.

Direct comments/inquiries to:
Legislative Audit Division
Room 160, State Capitol
PO Box 201705
Helena MT 59620-1705

02-05

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FINANCIAL-COMPLIANCE AUDITS

Financial-compliance audits are conducted by the Legislative Audit Division to determine if an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States General Accounting Office. Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

Government Auditing Standards, the Single Audit Act Amendments of 1996 and OMB Circular A-133 require the auditor to issue certain financial, internal control, and compliance reports. This individual agency audit report is not intended to comply with these reporting requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2003, will be issued by March 31, 2004. The Single Audit Report for the two fiscal years ended June 30, 2001, was issued on March 26, 2002. Copies of the Single Audit Report, when available, can be obtained by contacting:

Single Audit Coordinator
Office of Budget and Program Planning
State Capitol
Helena MT 59620
Phone (406) 444-3616

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PO Box 201705
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LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor
John W. Northey, Legal Counsel

Deputy Legislative Auditors:
Jim Pellegrini, Performance Audit
Tori Hunthausen, IS Audit & Operations
James Gillett, Financial-Compliance Audit

January 2003

The Legislative Audit Committee
of the Montana State Legislature:

This is our report on the financial-compliance audit of the Montana State Fund for the two fiscal years ended June 30, 2002. The objectives of this audit include determining if the financial statements for fiscal year 2001-02, with comparative financial amounts for fiscal year 2000-01, present fairly the Montana State Fund's financial position at June 30 for each fiscal year and the results of its operation for the fiscal years then ended. We tested compliance with laws and regulations related to operations of the Montana State Fund.

Montana State Fund is a workers' compensation insurance company established by the state of Montana. It is a nonprofit, independent public corporation that provides Montana employers with an option for workers' compensation and occupational disease insurance. Montana State Fund is governed by a seven-member board of directors appointed by the Governor. State law separates funding sources for claims incurred before July 1, 1990 (Old Fund) and those incurred on or after July 1, 1990 (New Fund).

Montana State Fund management must set premium rates at amounts sufficient, when invested, to carry the estimated cost of all claims to maturity, to meet the reasonable expenses of conducting the business of the New Fund, and to maintain an excess of surplus over the amount produced by the National Association of Insurance Commissioners' risk-based capital requirements for a casualty insurer. The Old Fund costs are currently funded by investment earnings. The investments of the Montana State Fund are managed by the Montana Board of Investments and invested according to policies established in law. The prior audit report included no recommendations to Montana State Fund.

On page A-1, you will find the Independent Auditor's Report followed by the financial statements and accompanying notes. We issued an unqualified opinion which means the reader can rely on the presented information. Montana State Fund's response to our audit is on page B-1.

We thank the Montana State Fund staff for their cooperation and assistance during the audit.

Respectfully submitted,

Scott A. Seacat
Legislative Auditor

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Montana State Fund	Carl Swanson	President/CEO
	Mark Barry	Vice President, Corporate Support
	Lanny Hubbard	Vice President, Insurance Operations
	Peter Strauss	Vice President, Insurance Operations Support
	Nancy Butler	General Counsel

State Fund Board of Directors		Term Expires
	Herb Leuprecht	2005
	Tom Horn	2003
	Loretta Lynde	2003
	Wendy J. Susott	2003
	Derek Grewatz	2005
	Susan Knedler	2005
	Mark Cole	2005

For additional information concerning the Montana State Fund, contact Carl Swanson, President/CEO, at:

5 South Last Chance Gulch
Helena MT 59601
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Members of the audit staff involved in this audit were Jeane Carstensen-Garrett, Chris G. Darragh, John Fine, and Jeff Tamblyn.

LEGISLATIVE AUDIT DIVISION

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John W. Northey, Legal Counsel

Deputy Legislative Auditors:
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INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee
of the Montana State Legislature:

We have audited the accompanying Statements of Net Assets, New Fund and Old Fund, of the Montana State Fund, a component unit of the state of Montana, as of June 30, 2002 and 2001 and the related Statements of Revenues, Expenses and Changes in Fund Net Assets, New Fund and Old Fund, and the Statements of Cash Flows, New Fund and Old Fund, for each of the fiscal years then ended. The information contained in these financial statements is the responsibility of the Montana State Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Montana State Fund as of June 30, 2002 and 2001, and the results of its operations and of its cash flows for each of the fiscal years then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying Management Discussion and Analysis on page A-3 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Respectfully submitted,

James Gillett

James Gillett, CPA
Deputy Legislative Auditor

November 7, 2002

Room 160, State Capitol Building PO Box 201705 Helena, MT 59620-1705
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Description of Business

The Montana State Fund (MSF) is a nonprofit, independent public corporation established under Title 39, Chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. MSF is attached to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to MSF.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. If MSF is dissolved by an act of law, the money in MSF is subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA). MSF administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of an Old Fund Liability Tax . No State general fund money is used for MSF operations.

MSF financial statements are presented as a component unit in the State of Montana Comprehensive Annual Financial Report. MSF uses the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations. Under the accrual basis, MSF records revenues in the accounting period earned, if measurable, and records expenses in the period incurred, if measurable.

Financial Position – MSF

MSF's financial position strengthened from fiscal year 2001 to 2002. Total net assets grew from $168,982 in 2001 to $180,715 in 2002, or 6.9%. This growth is due to increased premium growth of 24.8%. Total net earned premium in 2002 was $92,972, up from $74,510 in 2001. An offset to the premium growth is increased benefit payments and operating expenses. Benefit payments increased 21.6% and operating expenses increased 10.2%. The following discussion will explain the reasons for these changes and provide additional background to MSF's financial position.

(All dollar values are expressed in 000's.)

Assets

In fiscal year 2001 MSF changed its investment strategy to include the purchase of not only bonds but also equity securities. In 2002, the book value of equity securities increased to $74,000 from $24,000 in 2001. In 2002 equity securities' carrying value, which includes unrealized gains and losses, is $64,181 which is 12.4% of MSF's total cash and investments. In 2001 equity securities' carrying value was $23,704 which was 4.9% of MSF's total cash and investments. Total bonds in 2002 are $431,974, down from $432,056 in 2001. This results in a bond to total cash and investment ratio of 83.4% in 2002 compared to 88.8% in 2001. All investments are considered long term.

Net premiums receivable decreased to $4,427 in 2002 from $17,615 in 2001 due to a change in billing practices at the end of fiscal year 2002. In the prior year, the July 2001 billing took place on June 1, 2001, resulting in a large receivable balance with an offset to deferred revenue at June 30, 2001. In 2002, the July billing did not take place until July 1, 2002, resulting in much lower premium receivable and deferred revenue balances at June 30, 2002. The decrease in deferred revenue is illustrated below in the *Liabilities* section. Net receivables are expected to be collectible within one year. Other receivables for fiscal year 2002 consist of interest receivables of $6,441 and notes receivable of $223, of which $52 is long term. Other receivables for fiscal year 2001 consist of interest receivables of $7,164 and notes receivable of $152, of which $55 is long term.

Equipment increased $329 in 2002 from 2001 due to acquisitions of $550 offset by retirements of $221. Accumulated depreciation increased $446 from year to year due to depreciation expense of $568 and allocated depreciation expense of $70 to Old Fund offset by retirements of $192. Depreciation expense increased 93.2%, up from $294 in 2001 to $568 in 2002. This increase is due to changing the useful life of computer equipment from five to three years resulting in additional depreciation expense of $246 in 2002.

In fiscal year 2002 intangible assets decreased to $3,098 from $6,016 in 2001. The decrease is due to acquisitions of $279 offset by amortization expense of $3,091 and allocated amortization expense of $106 to Old Fund. Amortization expense increased 192.7%, up from $1,056 in 2001 to $3,091 in 2002. This increase is due to changing the useful life of intangible assets from seven to five years resulting in additional amortization expense of $1,997 in 2002.

Under the provisions of the state constitution, MSF's invested assets are managed by the Montana Board of Investments (BOI). The BOI has, by a Securities Lending Authorization Agreement, authorized the custodial bank to lend MSF's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. State Street Bank was appointed the BOI's custodial bank on December 1, 1993. During the period the securities are on loan, BOI receives a fee and the bank must initially receive collateral equal to 102% of the market value of the securities on loan and must maintain collateral equal to not less than 100% of the market value of the loaned security. BOI retains all rights of ownership during the loan period. The total collateral held at the end of fiscal year 2002 was $57,563 compared to $88,689 in 2001, all of which is classified as a short term asset with an offsetting short term liability.

(All dollar values are expressed in 000's.)

Liabilities

Loss and loss adjustment expense reserves increased to $346,400 in fiscal year 2002 up from $325,900 in 2001. MSF's reserves are undiscounted and stated at an amount slightly above the independent actuary's best estimate as a precautionary move against potential adverse development in losses. The short term portions of the reserves are $71,934 and $58,400 for fiscal years 2002 and 2001, respectively. The long term portions of the reserves are $274,466 and $267,500 for fiscal years 2002 and 2001, respectively.

Deferred revenue decreased from $16,157 in 2001 to $584 in 2002. This large decrease is due to the change in MSF's billing practices as described above in the *Assets* section. The entire balance is classified as short term since the billings are for one year or less.

Property held in trust decreased to $2,141 in 2002 from $5,382 in 2001 primarily due to the commutation of MSF's aggregate stop loss reinsurance treaty. The treaty, effective July 1, 2000, included a provision for MSF to maintain a funds withheld account in the amount of $2,150 and $1,850 (plus accrued interest) for fiscal years 2002 and 2001, respectively. At June 30, 2001 the property held in trust account included the fiscal year 2001 balance of $1,850 funds withheld account plus $123 in accrued interest. In June of 2002, the treaty was commuted, resulting in the reversal of the $1,973 and a reduction of the liability account for fiscal year end 2002. Additionally, the commutation resulted in increasing net earned premium by the balance in the fund withheld account, or $4,000.

As discussed above in the *Assets* section, the BOI has a Securities Lending Authorization Agreement to lend MSF's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. The total collateral owed at the end of fiscal year 2002 was $57,563 compared to $88,689 in 2001, all of which is classified as a short term liability with an offsetting short term asset.

Net Assets

During fiscal year 2002, net assets increased $11,733, from $168,982 in 2001 to $180,715 in 2002. Net income before transfers contributed $4,350 to net assets and transfers contributed $7,383 to net assets. Total net assets are unrestricted.

Results of Operations – MSF

Net Premiums Earned

Net premiums earned in fiscal year 2002 totaled $92,972, up from $74,510 in 2001, a 24.8% increase. The increase is driven by significant new policies as well as an increase in Other States Coverage premium revenue. MSF writes Other States Coverage for Montana state-domiciled insureds that have locations in states other than Montana. The increase is also due to the commutation of the aggregate stop loss reinsurance treaty (see discussion above in *Liabilities*

(All dollar values are expressed in 000's.)

section). Reversal of the funds withheld account, without the effects of accrued interest, increased net earned premium by $4,000.

Investment-Related Income

Investment income decreased in 2002 by $22,041 or 45.1% over fiscal year 2001. The primary reason for this decrease is the change in unrealized gains and losses from year to year. In fiscal year 2002 there was an unrealized loss of $2,107 compared to an unrealized gain of $17,449 in fiscal year 2001. The remaining decrease is due to the transition of building equity investments into MSF's portfolio. No investment income is earned on equity securities, plus cash that would normally be invested in interest-bearing fixed securities is being used to purchase equity securities.

Net realized gains increased to $6,570 in 2002, up from $2,583 in 2001 primarily due to the sales of treasury bonds and treasury notes during the second and third quarters of fiscal year 2002. Net realized losses increased to $2,218 in 2002, up from $460 in 2001, primarily due to the $2,010 permanent write down of Enron bonds. Securities lending income decreased to $2,082 in 2002 from $5,795 in 2001. The associated expense also decreased to $1,853 in 2002 from $5,643 in 2001.

Other Income

In fiscal year 2002, MSF received $231 in royalty income for the sale of in-house developed software. Other income decreased from $1,350 in 2001 to $157 in 2002 primarily due to the administrative assessment to the Montana Department of Labor. The assessment is strictly a pass-through of funds. At June 30, 2001 a balance was owed whereas at June 30, 2002, the balance was paid prior to year end.

Operating Expenses

Benefits paid in 2002 are $89,731compared to $73,785 in 2001, resulting in an increase of $15,946. The increase is driven by two factors: increased medical costs and increased change in loss and loss adjustment expense reserve due to an increased level of exposure from growth in premiums written. Medical payments increased approximately $6,400 due to rising medical costs in general. The change in reserves increased $9,500 due to updated actuarial data, adverse development on prior year losses and an increase in loss exposures from increased premium writings.

Personal services increased from $11,084 in 2001 to $12,741 in 2002. This 14.9% change is the result of several factors, including gainsharing incentive payments of approximately $533 and a one-time payout due to the implementation of the new Personal Leave Program. In addition, salary merit adjustments and pay range adjustments occurred in fiscal year 2002 which increased salaries and salary related expenses.

(All dollar values are expressed in 000's.)

Contractual services increased $748 in fiscal year 2002. Commissions increased $1,498 due to the increase in business offset by a decrease in consulting and professional services of $716 with some additional miscellaneous savings.

Supplies and materials decreased to $596 in fiscal year 2002 from $1,031 in fiscal year 2001. The change is due to increased purchases of office equipment and minor software in fiscal year 2001 due to MSF's reorganization.

Depreciation expense for fiscal year 2002 increased $274 from fiscal year 2001 due to the change in useful life of computer equipment. Amortization expense for fiscal year 2002 increased $2,035 from fiscal year 2001 due to the change in useful life of intangible assets. See *Assets* discussion above for further explanation.

The $1,673 decrease in other operating expenses from fiscal year 2001 to fiscal year 2002 is primarily due to the pass-through administrative assessment to the Montana Department of Labor. This expense offsets the revenue described in the *Other Income* section above. At June 30, 2002, payment was made and accounts cleared, whereas a balance still remained at June 30, 2001.

Transfers

Section 39-71-2352 (5), MCA provides for the payment of excess funds from the Old Fund to MSF based on adequate funding levels in the Old Fund. The transfer amount in fiscal year 2002 is $7,408 and the transfer amount in fiscal year 2001 is $6,765.

Change in Net Assets

The change in net assets for fiscal year 2002 is $11,733 compared to $29,725 in fiscal year 2001, a decrease of $17,992. The primary reason for the decrease in fiscal year 2002 is lower investment income of $22,041 (see related discussion in *Investment-Related Income* above). The decrease in investment income was offset by the fiscal year gains on investments which are $3,987 higher in fiscal year 2002 than in fiscal year 2001.

Financial Position – Old Fund

Old Fund's financial position is stable and relatively consistent from fiscal year 2001 to 2002. Old Fund's primary source of income is investment income that helps to maintain adequate reserve levels to fund claims remaining from July 1, 1990 and prior. Fiscal year 2002 experienced lower investment income offset by lower operating expenses compared to fiscal year 2001, resulting in a decrease in the change in net assets for fiscal year 2002. The following discussion will provide additional background to Old Fund's financial position.

(All dollar values are expressed in 000's.)

Assets

Old Fund's investment portfolio consists of long term bonds which decreased to $109,351 in fiscal year 2002 from $116,383 in fiscal year 2001. The bond to total cash and investment ratio for 2002 is 95.3% compared to 91.7% for 2001. As reserve levels decrease and funds are transferred out of Old Fund, monies to be invested decrease. For further explanation, see the reserve and transfer discussions below in the *Liabilities* and *Transfers* sections.

Interest receivables for the year ended June 30, 2002 are $1,638 compared to $1,425 for year ended June 30, 2002. Net accounts receivable for 2002 total $794, up from $773 in 2001. Net accounts receivable consist of medical overpayments and remaining receivables from the Old Fund Liability Tax. The Old Fund Liability Tax receivable is offset by related deferred revenue of $611 in 2002 and $606 in 2001.

Old Fund is also a part of the BOI's Securities Lending Authorization Agreement and therefore has securities lending collateral with an offsetting securities lending liability at year end. The balance for 2002 is $16,600 and the balance for 2001 is $5,080.

Liabilities

Loss and loss adjustment expense reserves decreased to $90,900 at June 30, 2002 from $104,700 at June 30, 2001. Old Fund's reserves are discounted at 5.5% and are determined by an independent actuary's best estimate. Undiscounted reserves are $128,902 at June 30, 2002 and $148,476 as of June 30, 2001. Reserve levels will continue to decrease with time, since Old Fund has no new claims but continues to pay on already-existing claims. As reserve levels decrease, so will the need to fund those levels resulting in decreasing investment needs over time. This trend is evident with the lower 2002 reserve and investment balances when compared to 2001. The short term portions of the reserves are $11,708 and $14,500 for fiscal years 2002 and 2001, respectively. The long term portion of the reserves are $79,192 and $90,200 for fiscal years 2002 and 2001, respectively.

Results of Operations – Old Fund

Investment-Related Income

Investment income is $9,576 in fiscal year 2002, down from $13,046 in fiscal year 2001. The decrease is primarily due to a reduction in unrealized gains on investments. In fiscal year 2002 the unrealized gain is $2,598 compared to an unrealized gain of $4,912 in fiscal year 2001. The remaining decrease is due to lower bond investment levels (see discussion above in the *Assets* section).

Operating Expenses

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents

(All dollar values are expressed in 000's.)

occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to $1,250 for both fiscal years 2002 and 2001. MSF allocated $1,250 in administration costs to the Old Fund in fiscal years 2002 and 2001. The Old Fund has a $1,019 obligation to MSF in unrecovered administrative costs incurred in fiscal years 2002 and prior. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted $1,250.

Transfers

Section 39-71-2352 (5), MCA provides for the payment of excess funds from the Old Fund to MSF based on adequate funding levels in the Old Fund. The transfer amount in fiscal year 2002 is $7,408 and the transfer amount in fiscal year 2001 is $6,765.

Change in Net Assets

The change in net assets for fiscal year 2002 is $2,084 compared to $4,222 in fiscal year 2001, resulting in a decrease of $2,138. The primary reason for the decrease in fiscal year 2002 is lower investment income of $3,470 (see related discussion in *Investment-Related Income* above) offset by lower benefits and claims due to the reduction of the estimated claims liability (see related discussion the *Liability* section above).

MONTANA STATE FUND - NEW FUND
STATEMENT OF NET ASSETS
The State Fund is a component unit of the State of Montana

JUNE 30,	2002 (in thousands)	2001 (in thousands)
ASSETS		
Current Assets		
Cash and cash equivalents	22,035	31,029
Receivables, net	11,039	24,876
Due from other funds	1,173	1,425
Securities lending collateral	57,563	88,689
Other assets	1,672	686
Total Current Assets	93,482	146,705
Noncurrent Assets		
Investments	496,155	455,760
Notes and loans receivable	52	55
Equipment	3,094	2,765
Accumulated depreciation	(1,903)	(1,457)
Intangible assets	3,098	6,016
Total Noncurrent Assets	500,496	463,139
Total Assets	593,978	609,844
LIABILITIES		
Current Liabilities		
Accounts payable	3,723	2,433
Due to other funds	1,291	1,105
Estimated claims payable	71,934	58,400
Compensated absences	815	745
Lease payable	68	7
Securities lending liability	57,563	88,689
Deferred revenue	584	16,157
Property Held in Trust	2,141	5,382
Total Current Liabilities	138,119	172,918
Noncurrent Liabilities		
Estimated claims payable	274,466	267,500
Compensated absences	455	416
Lease payable	223	28
Total Noncurrent Liabilities	275,144	267,944
Total Liabilities	413,263	440,862
NET ASSETS		
Invested in Capital Assets	4,289	7,324
Unrestricted	176,426	161,658
Total Net Assets	180,715	168,982
Total Liabilities and Net Assets	593,978	609,844

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - NEW FUND
STATEMENT OF REVENUES, EXPENSES, and CHANGES IN FUND NET ASSETS
The State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2002 (in thousands)	2001 (in thousands)
Net Premiums Earned	92,972	74,510
Operating Expenses		
Benefits and claims	89,731	73,785
Personal services	12,741	11,084
Contractual services	7,137	6,389
Supplies and materials	596	1,031
Depreciation	568	294
Amortization	3,091	1,056
Rent and utilities	199	208
Communications	937	1,062
Travel	221	185
Repair and maintenance	488	540
Interest expense	14	5
Other operating expenses	682	2,355
Total Operating Expenses	116,405	97,994
Operating Income (Loss)	(23,433)	(23,484)
Nonoperating Revenue (Expenses)		
Investment income	26,807	48,848
Gains on investments	6,570	2,583
Securities lending income	2,082	5,795
Losses on investments	(2,218)	(460)
Securities lending expense	(1,853)	(5,643)
Royalties	230	-
Penalties and interest	23	20
Other income	157	1,350
Dividend expense	(4,001)	(4,995)
Gain (loss) on retirement of assets	(14)	(41)
Total Nonoperating Revenue (Expenses)	27,783	47,457
Income before transfers	4,350	23,973
Transfer in	7,408	6,765
Transfer out	(25)	-
Prior Period Adjustments	-	(1,013)
Change in Net Assets	11,733	29,725
Total Net Assets - Beginning	168,982	139,257
Total Net Assets - Ending	180,715	168,982

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - NEW FUND
STATEMENT OF CASH FLOWS
The State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2002 (in thousands)	2001 (in thousands)
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts for Premiums	88,132	76,697
Payments to Suppliers for Goods and Services	(10,556)	(12,733)
Payments to Employees	(12,102)	(10,796)
Cash Payments for Claims	(69,168)	(61,436)
Other Operating Receipts	406	1,491
Other Operating Payments	(4,001)	(4,995)
Net Cash Provided by (Used for) Operating Activities	(7,289)	(11,772)
CASH FLOWS FROM NONCAPITAL FINANCIAL ACTIVITIES		
Transfers from Other Funds	7,408	6,765
Transfers to Primary Government	(25)	-
Net Cash Provided by (Used for) Noncapital Financing Activities	7,383	6,765
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Acquisition of Fixed Assets	(600)	(1,337)
Proceeds from Sale of Fixed Assets	15	(1)
Net Cash Used for Capital and Related Financing Activities	(585)	(1,338)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of Investments	(210,938)	(138,855)
Proceeds from Sales or Maturities of Investments	168,349	112,748
Proceeds from Securities Lending Transactions	2,082	5,998
Payments of Security Lending Costs	(2,083)	(5,847)
Interest and Dividends on Investments	34,087	33,377
Net Cash Provided by (Used For) Investing Activities	(8,503)	7,421
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(8,994)	1,076
CASH AND CASH EQUIVALENTS - JULY 1	31,029	29,953
CASH AND CASH EQUIVALENTS - JUNE 30	22,035	31,029

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - NEW FUND
STATEMENT OF CASH FLOWS
The State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2002 (in thousands)	2001 (in thousands)
RECONCILIATION OF INCOME BEFORE TRANSFERS TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES		
Income Before Transfers	4,350	23,973
Adjustments to Reconcile Operating Income to Net Cash Provided by (Used for) Operating Activities		
Depreciation	568	294
Amortization	3,091	1,056
Interest Expense	15	
Security Lending Costs	1,853	5,643
Security Lending Income	(2,082)	(5,795)
Interest on Investment	(31,159)	(50,971)
Decrease (Increase) in		
Accounts Receivable	13,169	(3,150)
Due From Other Funds	252	(933)
Notes Receivable	(52)	-
Inventories	-	27
Other Assets	(973)	(109)
Increase (Decrease) in		
Accounts Payable	1,451	1,108
Due to Other Funds	175	(96)
Deferred Revenue	(15,573)	1,564
Property Held in Trust	(3,240)	4,383
Estimated Claims	20,500	11,000
Lease Payable	257	-
Compensated Absences	109	234
Total adjustments	(11,639)	(35,745)
Net Cash Used for Operating Activities	(7,289)	(11,772)

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - OLD FUND
STATEMENT OF NET ASSETS

The State Fund is a component unit of the State of Montana

JUNE 30,	2002 (in thousands)	2001 (in thousands)
ASSETS		
Current Assets		
Cash and cash equivalents	5,406	10,465
Receivables, net	2,432	2,198
Due from other funds	1	1
Securities lending collateral	16,600	5,080
Total Current Assets	24,439	17,744
Noncurrent Assets		
Long term securities	109,351	116,383
Total Assets	133,790	134,127
LIABILITIES		
Current Liabilities		
Accounts payable	231	50
Due to other funds	519	846
Estimated claims payable	11,708	14,500
Deferred revenue	611	606
Securities lending liability	16,600	5,080
Total Current Liabilities	29,669	21,082
Noncurrent Liabilities		
Estimated claims payable	79,192	90,200
Compensated absences	63	63
Total Noncurrent Liabilities	79,255	90,263
Total Liabilities	108,924	111,345
NET ASSETS		
Restricted	13,178	7,408
Unrestricted	11,688	15,374
Total Net Assets	24,866	22,782
Total Liabilities and Net Assets	133,790	134,127

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - OLD FUND
STATEMENT OF REVENUES, EXPENSES, and CHANGES IN FUND NET ASSETS
The State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2002 (in thousands)	2001 (in thousands)
Operating Expenses		
Benefits and claims	(916)	691
Personal services	12	-
Contractual services	1,005	1,123
Depreciation	70	28
Amortization	106	-
Other operating expenses	349	331
Total Operating Expenses	626	2,173
Operating Income (Loss)	(626)	(2,173)
Nonoperating Revenue (Expenses)		
Investment income	9,576	13,046
Gains on investments	569	386
Securities lending income	235	394
Losses on investments	(86)	(394)
Securities lending expense	(204)	(385)
Liability tax	28	113
Total Nonoperating Revenue (Expenses)	10,118	13,160
Income before transfers	9,492	10,987
Transfer out	(7,408)	(6,765)
Change in Net Assets	2,084	4,222
Total Net Assets - Beginning	22,782	18,560
Total Net Assets - Ending	24,866	22,782

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - OLD FUND
STATEMENT OF CASH FLOWS
The State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2002 (in thousands)	2001 (in thousands)
CASH FLOWS FROM OPERATING ACTIVITIES		
Payments to Suppliers for Goods and Services	(1,856)	(1,138)
Payments to Employees	(12)	-
Cash Payments for Claims	(12,733)	(13,918)
Collection of Payroll Taxes	27	121
Other Operating Receipts	-	-
Net Cash Provided by (Used for) Operating Activities	(14,574)	(14,935)
CASH FLOWS FROM NONCAPITAL FINANCIAL ACTIVITIES		
Transfers to Other Funds	(7,408)	(6,765)
Net Cash Provided by (Used for) Noncapital Financing Activities	(7,408)	(6,765)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of Investments	(27,263)	(29,139)
Proceeds from Sales or Maturities of Investments	36,907	44,054
Proceeds from Securities Lending Transactions	234	393
Payments of Security Lending Costs	(190)	(402)
Interest and Dividends on Investments	7,235	8,279
Net Cash Provided by (Used For) Investing Activities	16,923	23,185
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(5,059)	1,485
CASH AND CASH EQUIVALENTS - JULY 1	10,465	8,980
CASH AND CASH EQUIVALENTS - JUNE 30	5,406	10,465

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - OLD FUND
STATEMENT OF CASH FLOWS
The State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2002 (in thousands)	2001 (in thousands)
RECONCILIATION OF INCOME BEFORE TRANSFERS TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES		
Income Before Transfers	9,492	10,987
Adjustments to Reconcile Operating Income to Net Cash Provided by (Used for) Operating Activities		
Security Lending Costs	205	385
Security Lending Income	(235)	(394)
Interest on Investment	(10,060)	(13,036)
Decrease (Increase) in		
Accounts Receivable	(21)	10
Due From Other Funds	-	10
Other Assets	-	16
Increase (Decrease) in		
Accounts Payable	167	38
Due to Other Funds	(327)	345
Deferred Revenue	5	(51)
Estimated Claims	(13,800)	(13,245)
Other Liabilities	-	-
Total adjustments	(24,066)	(25,922)
Net Cash Used for Operating Activities	(14,574)	(14,935)

The notes to the financial statements are an integral part of this statement.

1. Summary of Significant Accounting Policies

Description of Business

The Montana State Fund (MSF) is a nonprofit, independent public corporation established under Title 39, Chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. MSF is attached to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to MSF.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. If MSF is dissolved by an act of law, the money in MSF is subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA). MSF administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of an Old Fund Liability Tax (see Note 4). No State general fund money is used for MSF operations.

MSF financial statements are presented as a component unit in the State of Montana Comprehensive Annual Financial Report. The fiscal year 2002 and 2001 financial statements are presented in conformance with GASB 34 which is a comparable format to the State of Montana Comprehensive Annual Financial Report. This presentation is different than that of fiscal year 2001, prior to implementation of GASB 34. Fiscal year 2001 financial statements have been restated to comply with GASB 34.

Basis of Accounting

MSF uses the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations. Under the accrual basis, MSF records revenues in the accounting period earned, if measurable, and records expenses in the period incurred, if measurable.

Cash and Cash Equivalents

Cash balances include demand deposits with the State Treasury. MSF also participates in the Montana Board of Investments Short Term Investment Pool (STIP). STIP balances are highly liquid investments with maturities of 397 days or less. There are no legal risks that the Montana Board of Investments (BOI) is aware of regarding any STIP investments. The market value of STIP approximates cost. MSF's STIP balance of $20,909 as of June 30, 2002 represented 1.39% of the total STIP. The Old Fund STIP balance of $5,192 as of June 30, 2002 represented 0.35% of the total STIP. MSF's STIP balance of $28,618 as of June 30, 2001 represented 1.70% of the total STIP. The Old Fund STIP balance of $10,243 as of June 30, 2001 represented 0.61% of the total STIP.

The STIP investments' credit risk is measured by investment grade ratings given individual securities. The BOI's policy requires that STIP investments have the highest rating in the short-term category by one and/or any Nationally Recognized Statistical Rating Organizations (NRSRO). The three NRSRO's include Standard and Poor's, Moody's Investors Service and Fitch, Inc.

Asset-backed securities constituted 60.75% of the BOI's total STIP portfolio as of June 30, 2002. Asset-backed securities have less credit risk than do securities not backed by pledged assets. Market risk for asset-backed securities is the same as market risk for similar non asset-backed securities. Asset-backed securities constituted 39.79% of the Board of Investment's total STIP portfolio as of June 30, 2001.

Variable rate (floating rate) securities made up 32.71% of the BOI's total STIP portfolio as of June 30, 2002. Variable rate securities made up 17.98% of the BOI's total STIP portfolio as of June 30, 2001. While variable rate securities have credit risk identical to similar fixed rate securities, their market risk (income) is more sensitive to interest rate changes. However, the market risk (value/price) may be less volatile than fixed rate securities because their value will usually remain at or near par as a result of their interest rates being periodically reset to maintain a current market yield.

Investments

In addition to STIP investments, MSF invests in long-term securities with the BOI. Securities are stated at fair value as defined and required by Governmental Accounting Standards Board (GASB) Statement Number 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools". Premiums and discounts are amortized using the straight-line method over the life of the securities. Net unrealized gains or losses on securities are included in net income in accordance with GASB 31.

MSF investments are classified in risk Category 1 or as Not Categorized under State of Montana

(All dollar values are expressed in 000's.)

standards. Risk category 1 includes investments that are insured or registered and held by the BOI or its agent in the BOI's name. Not Categorized includes investments held by broker-dealers under loans with cash collateral. Asset-backed securities have less credit risk than do securities not backed by pledged assets. Market risk for asset-backed securities is the same as market risk for similar non asset-backed securities.

Under the provisions of state statutes, the BOI has, by a Securities Lending Authorization Agreement, authorized the custodial bank to lend the BOI's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. State Street Bank was appointed the BOI's custodial bank on December 1, 1993. During the period the securities are on loan, the BOI receives a fee and the bank must initially receive collateral equal to 102% of the market value of the securities on loan and must maintain collateral equal to not less than one hundred percent of the market value of the loaned security. The BOI retains all rights and risks of ownership during the loan period.

During fiscal years ended June 30, 2002 and June 30, 2001, State Street loaned, on behalf of the BOI, certain securities held by State Street, as custodian, and received U.S. dollar currency cash, U.S. Government securities, and irrevocable bank letters of credit. State Street does not have the ability to pledge or sell collateral securities unless the borrower defaults.

The BOI did not impose any restrictions during fiscal years 2002 and 2001 on the amount of the loans that State Street made on its behalf. There were no failures by any borrowers to return loaned securities or pay distributions thereon during fiscal years 2002 and 2001. There were no losses during fiscal years 2002 and 2001 resulting from default of the borrowers or State Street.

During fiscal years ended June 30, 2002 and June 30, 2001, the BOI and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality trust. The relationship between the average maturities of the investment pool and the BOI's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the BOI could not determine. On June 30, 2002 and June 30, 2001, the BOI had no credit risk exposure to borrowers.

The following table presents the carrying and market values of the securities on loan and the total collateral held for fiscal years ended June 30, 2002 and June 30,2001 for both MSF and the Old Fund:

	MSF		Old Fund	
	Fiscal Year 2002	Fiscal Year 2001	Fiscal Year 2002	Fiscal Year 2001
Securities on Loan-Book Value	$52,189	$80,459	$15,567	$4,743
Securities on Loan-Market Value	$55,652	$85,194	$16,023	$4,871
Total Collateral Held	$57,563	$88,689	$16,600	$5,080

As of June 30, 2002, investments in MSF and the Old Fund include $52,189 (approximately 11.8 % of total long-term securities), and $15,567 (approximately 3.5% of total long-term securities), respectively, in long-term securities on loan that earned interest income during the fiscal year of $2,082 and $235 respectively.

As of June 30, 2001, investments in MSF and the Old Fund include $80,459 (approximately 18.8% of total long-term securities), and $4,743 (approximately 1.1% of total long-term securities), respectively, in long-term securities on loan that earned interest income during the fiscal year of $5,795 and $394 respectively.

During fiscal year 2002, the BOI decreased the book value of one long-term bond by $2,010 for MSF. During fiscal year 2001, the BOI decreased the book value of one long-term bond by the amounts of $420 for MSF and $387 for Old Fund. The write-downs for both fiscal years were recorded as investment losses.

In November 2000, the Montana Constitution was amended to allow investing in equity securities, with the restriction that equity securities cannot exceed 25% of total investment book value. As of June 30, 2002, equity securities in MSF include $74,000 at book value, offset by $9,819 in market value depreciation. As of June 30, 2001, equity securities in MSF include $24,000 at book value, offset by $296 in market value depreciation.

Receivables

MSF's premium receivable balance of $4,821 at June 30, 2002 includes $3,064 of premium due from insureds for insurance coverage provided during fiscal year 2002 not yet received. The remaining $1,757 represents advance premiums billed but not received for insurance coverage effective July 1, 2002 as part of the MSF's Premium in Advance program. This amount is offset in deferred revenue. Estimated uncollectible receivables are reported as an allowance for doubtful accounts of $394. Other receivables include $6,441 in investment income due and $223 in notes and loans receivable, of which $52 is long term.

(All dollar values are expressed in 000's.)

MSF's premium receivable balance of $18,009 at June 30, 2001 includes $4,024 of premium due from insureds for insurance coverage provided during fiscal year 2001 not yet received. The remaining $13,985 represents advance premiums billed but not received for insurance coverage effective July 1, 2001 as part of the MSF's Premium in Advance program. This amount is offset in deferred revenue. Estimated uncollectible receivables are reported as an allowance for doubtful accounts of $394. Other receivables include $7,164 in investment income due, $152 in notes and loans receivable, of which $55 is long term.

The decrease in premium receivable from fiscal year 2002 to fiscal year 2001 is due to a change in billing practices. In fiscal year 2001, the July 2001 billing took place on June 1, 2001, resulting in a large receivable balance with an offset to deferred revenue at June 30, 2001. In 2002, the July billing did not take place until July 1, 2002, resulting in much lower premium receivable and deferred revenue balances at of June 30, 2002.

Accounts receivable in the Old Fund includes amounts due from past premiums in dispute or in collection and amounts due from Old Fund Liability Tax collections. Net accounts receivable for year ended June 30, 2002 and June 30, 2001 were $794 and $773, respectively. Estimated uncollectible receivables are reported as an allowance for doubtful accounts. Interest receivable of $1,638 at June 30, 2002 and $1,425 at June 30, 2001 represents investment income due.

Equipment and Accumulated Depreciation

Equipment is capitalized if the actual or estimated historical cost exceeds $5. Depreciation expense is computed on a straight-line basis for equipment over a period of three to five years for fiscal year ended June 30, 2002 and five to ten years for fiscal year ended June 30, 2001. Amortization of intangible assets is computed on a straight-line basis over five years for fiscal year ended June 30, 2002 and a period of three to seven years for fiscal year ended June 30, 2001. Amortization of intangible assets is applied directly to the asset balance. During fiscal year ended June 30, 2002, the useful lives of computer equipment and intangible assets were reduced to three and five years, respectively. As a result, additional depreciation expense of $246 and amortization expense of $1,997 was recognized for the year ended June 30, 2002. All fixed assets are recorded in the MSF. Because MSF administers the Old Fund, the Old Fund does not carry fixed assets.

Other Assets

Other assets include security deposits from certain policyholders that secure payment of premiums. Also included are deferred acquisition costs incurred during the policy writing process and that are recognized ratably over the related policy term.

Deferred Revenue

Deferred revenue reflects amounts in advance that are received or billed, but not yet earned for policies effective July 1, 2002 or July 1, 2001.

Net Assets

Net assets consist of the net excess or deficit of assets over liabilities.

Premiums

The MSF Board of Directors approves premium rates annually. Policies are effective for the term of the policy period not to exceed 12 months. Revenue from premiums is recognized over the term of the fiscal year, which runs from July 1 through June 30.

Policyholders are contractually obligated to pay certain premiums to MSF in advance of the period the premiums are earned. Premium advances are refundable when the policyholder's coverage is canceled and all earned premiums have been credited by MSF.

Presentation

The financial statements are presented in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board. MSF insurance operations are classified as an Enterprise Fund, Proprietary Fund type.

The Enterprise Fund of the MSF is part of, but does not comprise, the entire Enterprise Fund of the State of Montana. The financial statements in this report reflect the financial position and results of operations and cash flows of MSF and Old Fund, not the State of Montana.

The Enterprise Fund is used to account for operations: (a) financed and operated in a manner similar to private business enterprises, where the legislature intends that the entity finance or recover costs primarily through user charges; or (b) where the legislature has decided that periodic determination of revenues earned, expenses incurred, or net income is appropriate.

According to GASB Statement No. 31, Accounting and Financial Reporting for Certain Investments and External Investment Pools, STIP is considered an external investment pool. An external investment pool is defined as an arrangement that pools the monies of more than one legally separate entity and invests, on the participant's behalf, in an investment portfolio. STIP is also classified as a "2a7-like" pool. A 2a7-like pool is an external investment pool that is not

(All dollar values are expressed in 000's.)

registered with the Securities and Exchange Commission (SEC) as an investment company, but has a policy that it will, and does, operate in a manner consistent with the SEC's Rule 2a7 of the Investment Company Act of 1940. If certain conditions are met, 2a7-like pools are allowed to use amortized cost rather than fair value to report net assets to compute unit values. The Board of Investments has adopted a policy to treat STIP as a 2a7-like pool.

See Note 2 for further discussion of the effect of GASB 31.

2. Investments

The amortized cost and market value of MSF's fixed maturity securities as of June 30, 2002, and June 30, 2001, are as follows:

		Gross Unrealized		
June 30, 2002	Amortized Cost	Gains	Loss	Market Value
Government Direct-Indirect	$ 115,258	$ 5,914	$ -	$ 121,172
Government Mortgage-Backed	74,848	1,337	-	76,185
Corporate Securities Asset-Backed	13,001	141	-	13,142
Other Corporate Securities	204,621	9,796	1,056	213,361
Other Securities	7,954	278	118	8,114
Equity Securities	74,000	-	9,819	64,181
STIP (reported as Cash & Cash Equivalents)	20,909	-	-	20,909
Total	$ 510,591	$ 17,466	$ 10,993	$ 517,064

		Gross Unrealized		
June 30, 2001	Amortized Cost	Gains	Loss	Market Value
Government Direct-Indirect	$ 144,862	$ 6,770	$ 795	$ 150,837
Government Mortgage-Backed	46,787	295	604	46,478
Corporate Securities Asset-Backed	20,223	324	-	20,547
Other Corporate Securities	204,339	5,191	1,924	207,606
Other Securities	6,970	48	430	6,588
Equity Securities	24,000	-	296	23,704
STIP (reported as Cash & Cash Equivalents)	28,618	-	-	28,618
Total	$ 475,799	$ 12,628	$ 4,049	$ 484,378

(All dollar values are expressed in 000's.)

The amortized cost and estimated market value of MSF's fixed maturity securities as of June 30, 2002 and June 30, 2001, are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

June 30, 2002

	Amortized Cost	Market Value
Due one year or less	$ 27,913	$ 27,899
Due after one year through five years	162,358	171,111
Due after five years through ten years	131,440	135,976
Due after ten years	114,880	117,897
Equity Securities	74,000	64,181
Totals	$ 510,591	$ 517,064

June 30, 2001

	Amortized Cost	Market Value
Due one year or less	$ 33,656	$ 33,068
Due after one year through five years	165,505	170,332
Due after five years through ten years	125,897	129,727
Due after ten years	126,741	127,547
Equity Securities	24,000	23,704
Totals	$ 475,799	$ 484,378

During fiscal year ending June 30, 2002, MSF realized gross gains from sales of securities of $6,570 and gross realized losses of $2,218. During fiscal year ending June 30, 2001, MSF realized gross gains from sales of securities of $2,583 and gross realized losses of $460.

As discussed in Note 1, GASB 31 requires governmental entities to state their investments at fair value. Fair value is defined as the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The adjustment to fair value is reflected as an increase or decrease in investment income. During fiscal year 2002, investment income for MSF was adjusted downward $2,107 due to the unrealized loss on long-term investments. Investment income for fiscal year 2001 was adjusted upward $17,449 for the unrealized gain that occurred during that year on long-term investments.

(All dollar values are expressed in 000's.)

The amortized cost and market value of the Old Fund fixed maturity securities as of June 30, 2002 and June 30, 2001 are as follows:

June 30, 2002	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Loss	Market Value
Government Direct-Indirect	$ 52,358	$ 1,490	$ -	$ 53,848
Government Mortgage-Backed	11,999	295	-	12,294
Corporate Securities Asset-Backed	5,442	112	-	5,554
Other Corporate Securities	34,595	892	652	34,835
Other Securities	2,997	-	177	2,820
STIP (reported as Cash & Cash Equivalents)	5,192	-	-	5,192
Total	$ 112,583	$ 2,789	$ 829	$ 114,543

June 30, 2001	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Loss	Market Value
Government Direct-Indirect	$ 41,251	$ 331	$ 804	$ 40,778
Government Mortgage-Backed	15,783	-	229	15,554
Corporate Securities Asset-Backed	19,386	236	-	19,622
Other Corporate Securities	35,591	450	269	35,772
Other Securities	5,009	32	384	4,657
STIP (reported as Cash & Cash Equivalents)	10,243	-	-	10,243
Total	$ 127,263	$ 1,049	$ 1,686	$ 126,626

The amortized cost and market value of the Old Fund fixed maturity securities as of June 30, 2002 and June 30, 2001 are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(All dollar values are expressed in 000's.)

June 30, 2002

	Amortized Cost	Market Value
Due one year or less	$ 8,185	$ 8,205
Due after one year through five years	62,145	63,049
Due after five years through ten years	39,191	40,164
Due after ten years	3,062	3,125
Totals	$ 112,583	$ 114,543

June 30, 2001

	Amortized Cost	Market Value
Due one year or less	$ 10,243	$ 10,243
Due after one year through five years	51,131	51,394
Due after five years through ten years	26,534	26,656
Due after ten years	39,355	38,333
Totals	$ 127,263	$ 126,626

During fiscal year 2002, investment income for the Old Fund was increased $ 2,598 due to the unrealized gain on its long-term portfolio. During fiscal year 2001, the effect of GASB 31 on Old Fund investment income was an increase of $ 4,912.

During the fiscal year ended June 30, 2001, the Old Fund realized $569 in gross gains from sales of securities and gross realized losses of $86. During the fiscal year ended June 30, 2001, the Old Fund realized $386 in gross gains from sales of securities and $394 in gross realized losses.

3. Reinsurance

For the fiscal years ended June 30, 2002 and June 30, 2001 MSF ceded reinsurance to other insurance companies to limit the exposure arising from large losses. These arrangements consisted of excess of loss contracts that protect against losses over stipulated amounts and an aggregate stop loss contract. The aggregate stop loss contract covered fiscal years 2002 and 2001 however the contract was commuted prior to June 30, 2002. During fiscal year 2002 and 2001 MSF retained the first $3,000 with a $500 aggregate annual deductible for the first layer of reinsurance coverage. Individual, per person coverage was provided up to $5 million per claimant and is subject to an annual limit of $10 million. In the event reinsurers are unable to meet their obligations, MSF would remain liable for all losses, as the reinsurance agreements do

(All dollar values are expressed in 000's.)

not discharge MSF from its primary liability to the policyholders.

MSF purchased reinsurance coverage for employers' liability insurance offered to policyholders during fiscal years 2001. MSF retains the first $200 in ultimate net loss for any one occurrence while reinsurers are liable for losses in excess of $200 up to a limit of $1,000. MSF did not purchase reinsurance coverage for employers' liability insurance during fiscal year 2002.

As the result of commuting the aggregate stop loss contract, premium revenue is increased by $465 due to the reversal of the funds withheld account offsetting premiums paid for reinsurance coverage. Premium revenue is reduced by premiums paid for reinsurance coverage of $2,952 in fiscal year 2001.

During fiscal years 2002 and 2001, estimated claim reserves were reduced $6,500 and $4,000 respectively, for the amount of reinsurance estimated to be ultimately recoverable on incurred losses.

MSF also has assumed reinsurance relationships with Fireman's Fund Insurance Company and Legion Insurance Company related to Other States Coverage (OSC). MSF assumes risk for OSC claims, which are then covered under the MSF's ceded reinsurance contract. Assumed premium for fiscal years 2002 and 2001 are $1,582 and $826, respectively.

4. Risk Management/Public Entity Risk Pool

MSF and the Old Fund are public entity risk pools. Neither fund had significant reductions in insurance coverage from the prior year, nor any insurance settlements exceeding insurance coverage. Unpaid claims and claims adjustment expenses are estimated based on the ultimate cost of settling the claims including the effects of inflation and other socioeconomic factors.

MSF provides liability coverage to employers for injured employees that are insured under the Workers' Compensation and Occupational Disease Acts of Montana. Workers' compensation claims occurring on or after July 1, 1990, are reported in the MSF. MSF must insure any employer who desires coverage. At June 30, 2002, approximately 24,961 employers were insured by MSF. At June 30, 2001, approximately 23,915 employers were insured by MSF. Anticipated investment income is considered when computing premium rate levels and employers must pay premiums to MSF within specified time frames.

Tillinghast-Towers Perrin prepared an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported for MSF as of June 30, 2002 and June 30, 2001. Because actual claim costs depend on such

(All dollar values are expressed in 000's.)

complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors.

A provision for inflation and the calculation of estimated future claim costs is implicit in the calculation because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience. As of June 30, 2002, $346,400 of unpaid claims and claim adjustment expenses are presented at face value net of estimated reinsurance recoverable. As of June 30, 2001, $325,900 of unpaid claims and claim adjustment expenses are presented at face value. When MSF purchases annuity contracts, the claim is settled in full and on a final basis, and all liability of MSF is terminated.

State law requires MSF to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. State law also requires the MSF Board of Directors to establish surplus above risk based capital requirements to secure MSF against risks inherent in the business of insurance.

Acquisition costs represent costs associated with the acquisition of new insurance contracts or renewal of existing contracts and include agent commissions and expenses incurred in the underwriting process. MSF acquisition costs are capitalized and amortized ratably over the subsequent year. Capitalized acquisition costs at June 30, 2002 and June 30, 2001 are $878 and $389 respectively. For the years ended June 30, 2002 and June 30, 2001, acquisition costs that were amortized are $389 and $171 respectively.

The Old Fund covers the liability and payment of workers' compensation claims for incidents occurring before July 1, 1990. Funding for claims payments was provided by Old Fund Liability Taxes (OFLT). The OFLT is no longer in effect, however, revenue on past taxes is still being received and totaled $28 and $113 for June 30, 2002 and June 30, 2001, respectively.

An actuarial study prepared by Tillinghast-Towers Perrin for the Old Fund as of June 30, 2002 and June 30, 2001, was used to estimate liabilities and the ultimate cost of settling claims that have been reported, but not settled and claims that have been incurred, but not reported. As of June 30, 2002, $128,902 of unpaid claims and unpaid claim adjustment expenses are presented at their net present value of $90,900 discounted at a 5.5% rate. As of June 30, 2001, $148,476 of unpaid claims and unpaid claim adjustment expenses are presented at their net present value of $104,700. Total Old Fund surplus as of June 30, 2002 is $24,866 compared to $22,782 as of June 30, 2001.

(All dollar values are expressed in 000's.)

Montana State Fund
(A Component Unit of the State of Montana)
Notes to Financial Statements
June 30, 2002 and 2001

Changes in Claims Liabilities for the Past Two Years

The following table presents changes in the aggregate liabilities for MSF and the Old Fund for the past two years net of estimated reinsurance recoverable. The information presented has not been discounted.

	MSF		Old Fund	
	2002	2001	2002	2001
Unpaid claims and claim adjustment expenses at beginning of year	$325,900	$314,900	$148,476	$167,915
Incurred claims and claim adjustment expenses:				
Provision for insured events of the current year	84,370	75,465		
Increase (decrease) in provision for events of prior years	5,361	(1,667)	(6,690)	(5,503)
Total incurred claims and claim adjustment expenses	89,731	73,798	(6,690)	(5,503)
Payments:				
Claims and claim adjustment expenses attributable to insured events of the current year	(16,693)	(14,140)		
Claims and claim adjustment expenses attributable to insured events of prior years	(52,538)	(48,658)	(12,884)	(13,936)
Total Payment	(69,231)	(62,798)	(12,884)	(13,936)
Total unpaid claims and claim adjustment expenses at end of year	$346,400	$325,900	$128,902	$148,476

Risk Management Trend Information

The following table illustrates how the earned revenues of MSF plus investment income compare to related costs of loss and other expenses assumed by MSF for fiscal years 1993 through 2002. In addition, cumulative amounts related to estimated and actual paid claims are presented. The information allows for comparison of actual and estimated claims and is a basis for developing revenue and claims information. As data for individual policy years mature, the correlation between original estimates and re-estimated amounts is used to evaluate the accuracy of incurred claims currently recognized for less mature policy years.

(All dollar values are expressed in 000's.)

Montana State Fund
(A Component Unit of the State of Montana)
Notes to Financial Statements
June 30, 2002 and 2001

New Fund	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
1. Premiums and Investment Revenue										
Earned	214,793	231,793	190,685	134,771	102,233	87,305	78,482	86,786	109,248	105,483
Ceded	289	318	269	519	348	303	260	855	2,952	(465)
Net Earned	214,504	231,475	190,416	134,252	101,885	87,002	78,222	85,931	106,296	105,948
2. Unallocated expenses including overhead	7,758	8,890	15,049	18,013	13,136	15,061	19,745	23,189	28,097	32,679
3. Estimated losses and expenses, end of accident year										
Incurred	186,480	199,890	164,628	95,067	76,067	64,983	64,645	65,957	68,267	81,560
Ceded	-	-	-	-	-	-	-	-	-	-
Net Incurred	186,480	199,890	164,628	95,067	76,067	64,983	64,645	65,957	68,267	81,560
4. Net paid (cumulative) as of:										
End of policy year	18,347	18,693	18,137	15,818	12,589	12,943	13,723	13,177	14,140	16,693
One year later	46,343	45,947	40,473	32,890	28,451	28,222	29,976	29,218	32,888	-
Two years later	62,717	60,971	52,073	42,361	35,706	35,753	39,298	37,555	-	-
Three years later	71,666	67,576	58,722	47,283	39,860	41,004	45,748	-	-	-
Four years later	76,280	72,212	62,419	50,267	43,105	44,478	-	-	-	-
Five years later	80,165	75,799	65,919	52,791	46,478	-	-	-	-	-
Six years later	82,981	78,306	68,541	54,962	-	-	-	-	-	-
Seven years later	85,357	80,861	70,816	-	-	-	-	-	-	-
Eight years later	88,080	83,150	-	-	-	-	-	-	-	-
Nine years later	90,094	-	-	-	-	-	-	-	-	-
5. Re-estimated ceded losses and expenses	272	-	-	-	5,372	106	750	-	-	-
6. Re-Estimated net incurred losses and expense:										
End of policy year	186,480	199,890	164,628	95,067	76,067	64,983	63,807	65,957	68,267	81,560
One year later	184,030	184,920	124,123	88,923	67,235	64,308	64,348	66,421	71,094	-
Two years later	167,052	135,472	107,074	77,286	59,054	60,467	66,660	66,662	-	-
Three years later	133,017	116,756	95,456	73,864	60,811	61,989	69,345	-	-	-
Four years later	120,583	107,656	94,517	74,022	64,439	64,944	-	-	-	-
Five years later	111,208	105,052	92,231	73,197	59,079	-	-	-	-	-
Six years later	109,415	106,039	91,771	74,329	-	-	-	-	-	-
Seven years later	111,638	105,668	92,637	-	-	-	-	-	-	-
Eight years later	111,084	105,606	-	-	-	-	-	-	-	-
Nine years later	110,921	-	-	-	-	-	-	-	-	-
7. Increase (decrease) in estimated net incurred losses and expenses from end of policy year	(75,559)	(94,284)	(71,991)	(20,738)	(16,988)	(39)	4,700	705	2,827	0

(All dollar values are expressed in 000's.)

5. Administrative Cost Allocation

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to $1,250 for both fiscal years 2002 and 2001. MSF allocated $1,250 in administration costs to the Old Fund in fiscal years 2002 and 2001. The Old Fund has a $1,019 obligation to MSF in unrecovered administrative costs incurred in fiscal years 2002 and prior. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted $1,250.

6. MSF Surplus Distributions

Dividend Paid to Policyholders

During the fiscal years ended June 30, 2002 and June 30, 2001, the MSF Board of Directors authorized and paid dividends to policyholders for $4,001 and $4,995, respectively.

Transfer from Old Fund to MSF

Section 39-71-2352 (5), MCA provides for the payment of excess funds from the Old Fund to MSF based on adequate funding levels in the Old Fund (see Note 7). The transfer amount in fiscal year 2002 is $7,408 and the transfer amount in fiscal year 2001 is $6,765.

7. Old Fund Surplus Position

The State's Budget Director determined, based on the recommendation presented by the MSF Board of Directors in September 1998, that the Old Fund Liability Tax could end on January 1, 1999 in compliance with state law.

Because the Old Fund was determined to be adequately funded as of December 31, 1998, the Old Fund Liability Tax was terminated and a process was put in place to measure the status of the Old Fund's surplus level annually on a present value basis using a discount factor of 5.5% to determine compliance with state law requirements for maintaining fund adequacy.

State law defines the term "adequately funded" to mean the present value of:

a) the total cost of future benefits remaining to be paid; and,
b) the cost of administering the claims; and,
c) an amount equal to 10% of the total of the amounts in subsections (a) and (b) above.

(All dollar values are expressed in 000's.)

As of June 30, 2002 the Old Fund surplus level using a present value discount factor of 5.5% was $24,866. The 10% contingency required to be retained in excess of the full cost needed to cover the expense of the administration and payment of any unpaid claims equaled $9,090.

As of June 30, 2001 the Old Fund surplus level using a present value discount factor of 5.5% was $22,782. The 10% contingency required to be retained in excess of the full cost needed to cover the expense of the administration and payment of any unpaid claims equaled $10,470.

8. Compensated Absences

MSF supports two leave programs, the State of Montana Leave Program and the MSF Personal Leave Program, implemented in January 2002. The State of Montana Leave Program covers all union represented employees. Union represented employees accumulate both annual leave and sick leave and MSF pays employees 100% of unused annual leave and 25% of unused sick leave upon termination. MSF also pays 100% of unused compensatory leave credits upon termination to nonexempt employees. MSF Personal Leave Program covers all non-union employees. Non-union employees accumulate personal leave and extended leave. MSF pays employees for 100% of unused personal leave upon termination but extended leave has no cash value at the time of termination.

MSF absorbs expenditures for termination pay in its annual operational costs. MSF had a total leave liability of $1,333 and $1,224 at June 30, 2002 and 2001, respectively.

9. Pension Plan

MSF and its employees contribute to the Public Employees Retirement System (PERS), a mandatory multiple-employer, cost-sharing, defined benefit pension plan administered by the State of Montana Public Employees Retirement Administration (MPERA). The PERS offers retirement, disability and death benefits to plan members and their beneficiaries. Established in 1945, the plan is governed by Title 19, Chapters 2 and 3, MCA. PERS participants are eligible to retire at age 60 with at least five years of service, at age 65 regardless of length of service or at 30 years of service regardless of age. Actuarially reduced retirement benefits may be taken with 25 years of service or at age 50 with a minimum of five years of service. Monthly retirement benefits are calculated by taking 1/56 times the years of service times the final average salary. Vesting occurs once membership service totals 5 years. The authority to establish and amend contribution rates and to provide cost of living adjustments for the plan is assigned to the State legislature. MSF and its employees each were required to contribute 6.9% of annual compensation in fiscal years 2002 and 2001. MSF's contributions amounted to $723 for fiscal year 2002 and $583 for fiscal year 2001. MSF and its employees paid one hundred percent of required contributions to PERS and there is no

(All dollar values are expressed in 000's.)

unpaid liability as of June 30, 2001.

The PERS financial information is reported in the Public Employees' Retirement Board *Comprehensive Annual Financial Report* for the fiscal year-end. It is available from the MPERA at 100 North Park Avenue, Suite 220, P. O. Box 200131, Helena, MT 59620-0131, (406) 444-3154.

10. Building

The 1981 Legislature appropriated funds for the construction of a Workers' Compensation building. As of July 1, 1990, MSF transferred the value of the building from its records to the Department of Administration, which owns most other state buildings and charges agencies rent for their use. Under an agreement, MSF pays all costs associated with the building, including utilities, property taxes, janitorial services, and maintenance in lieu of paying rent.

11. Contingencies

Broeker v. State Fund. The issue in this case involved the way insurers calculated the social security disability offset rates on certain claims.

The Workers' Compensation Court decision stated that where there is a cost of living increase built into the initial entitlement to social security disability benefits, the workers' compensation insurer cannot take the cost of living increase into consideration when computing the SSDI offset rate. There is a cost of living offset built into the initial social security entitlement in those claims where the injured worker did not apply for social security disability close to the date of injury.

On appeal, the Montana Supreme Court affirmed the Workers' Compensation Court decision. This decision appears to affect those similarly situated claimants. The case was settled. The settlement provides for review of certain claims and Montana State Fund is proceeding in accordance with the terms of the settlement. The process is nearly complete.

Murer, et al v. Montana State Compensation Mutual Insurance Fund, et al. WCC No. 9206-6487, involves the 1987 legislature's capping of workers' compensation benefits ($ .299 a week for total benefits and $ .149 a week for partial benefits) for injuries occurring during the period July 1, 1987 through June 30, 1989. The 1989 legislature reenacted those caps for the period July 1, 1989 through June 30, 1991 for injuries occurring between July 1, 1989 and June 30, 1991.

The Montana Supreme Court found that these caps should have expired on June 30, 1989 for injuries occurring between July 1, 1987 and June 30, 1989, and should have expired on June 30, 1991 for injuries occurring between July 1, 1989 and June 30, 1991.

As a result, Montana State Fund, under Workers' Compensation Court direction, reviewed approximately 7500 claims. Those claims qualifying are paid 85% of the increased rate, with 15% paid to the claimant attorney. Cost impact is estimated to be over $1 million but with a cost no greater than $2 million. The review and payment process is near finalization.

State Compensation Insurance Fund v. George Berg, et al. Case No. DV-99-34 (Fergus County), is a pending suit against a former policyholder in which the Montana State Fund claims the policyholder failed to pay workers' compensation insurance premiums, plus interest on the unpaid premiums. The total claim was originally for $1,046, but on further evaluation has been reduced to approximately $660. Berg filed a counterclaim against Montana State Fund on various claims, seeking unspecified damages. The Montana State Fund does not think the counterclaim has merit, but there is a remote chance of an adverse judgment against Montana State Fund. This matter was expected to go to trial sometime during 2001. However, Berg filed a Chapter 11 bankruptcy petition in Montana Bankruptcy Court, which stayed any further proceedings in the state court action. Montana State Fund entered into a tentative settlement with Berg for payment of $100 cash, plus $125 payable over time. This settlement was subject to approval by the bankruptcy court in a Chapter 11 plan of reorganization. However, the bankruptcy court converted the case to Chapter 7 liquidation. This had the effect of resurrecting Montana State Fund's original claim amount of $660. At this time, we are not certain how much of this claim will be recovered.

Stavenjord v. State Compensation Insurance Fund. The Stavenjord case was issued by the Workers' Compensation Court on May 22, 2001. It addressed the issue of whether the failure of the Occupational Disease Act (ODA) to provide PPD (permanent partial disability) benefits equivalent to the benefits provided in the Montana WCA (Workers' Compensation Act) violates the claimant's right to equal protection of the law. Relying on the Henry case (previous case from the Supreme Court finding that vocational rehabilitation benefits must also be paid under the ODA), the court said it did, saying "Where PPD benefits calculated pursuant to the WCA are greater that the benefits available to a claimant under the ODA, constitutional equal protection guarantees require that benefits be computed and paid in accordance with the WCA. The claimant in this case is entitled to $27 under the WCA, versus $10 under the ODA." Preliminary estimates indicate that the *Stavenjord* decision will increase claim costs by nearly $1,000 a year for SCIF. The case is currently on appeal to the Montana Supreme Court.

12. Subsequent Events

As discussed in Note 6, excess funds from the Old Fund are transferred to MSF based on adequate funding levels in the Old Fund. During the State of Montana Special Legislative session in August, 2002, Senate Bill 19 was passed. Rather than transferring the full amount of Old Fund's fiscal year 2002 excess to MSF, Senate Bill 19 allocated $4,000 of the excess to the State of Montana's General Fund. The remainder is available for transfer to MSF during fiscal year 2003. The estimated total amount of excess in the Old Fund as of June 30, 2002 is $13,178.

(All dollar values are expressed in 000's.)

MONTANA
STATEFUND

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Carl W. Swanson, President/CEO

December 20, 2002

Scott Seacat
Legislative Audit Division
Rom 160, Capitol Building
Helena, MT 59620-1705

Dear Mr. Seacat:

The Montana State Fund extends our appreciation to the Legislative Audit Division staff for their review of the Montana State Fund operations. We are once again pleased with the unqualified opinion on the financial statements for the fiscal years ending June 30, 2002 and 2001 as presented in this report. We are equally pleased there are no audit recommendations contained in the report. We look at the results of the audit as confirmation of the financial credibility and financial strength of the Montana State Fund and a measure of our commitment in serving the businesses in Montana. Our Board of Directors also appreciates the review by the Legislative Audit Division in providing them an assessment of the financial results of the Montana State Fund.

Serving as Montana's guaranteed market for workers' compensation insurance, our financial stability and integrity assures that businesses have a viable option for purchasing their insurance coverage at the best possible cost to them. We serve as a driving force in workers' compensation insurance for our state. Our presence in the market promotes healthy competition that ultimately benefits all of our citizens. Living and working here in Montana, we understand the Montana business environment and are focused on providing the best possible care for injured employees. Our vision clearly guides our organization and sets us apart from other workers' compensation insurance carriers that operate in our state. *Montana State Fund is committed to the health and economic prosperity of Montana through superior service, leadership and caring individuals, working in an environment of teamwork, creativity and trust.*

Our continued focus on the financial strength of our organization will allow us to best serve the Montana business community and help to foster an environment to attract and grow business in our state. With the support of the Legislature, the Governor, and our business partners, MSF will continue to lead the way in providing for the workers' compensation insurance needs for Montana businesses. By fostering an environment that focuses on creativity and trust, we truly have become the insurance carrier of choice and industry leader in service. Our greatest satisfaction comes from the knowledge that by working together we have been able to make a difference to the people that we serve.

Sincerely,

Carl Swanson

Carl Swanson
President/CEO

Our mission is to be Montana's insurance carrier of choice and industry leader in service.